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INTERGOVERNMENTAL FISCAL TRANSFER SYSTEM AND POLITICALLY MOTIVATED TARGETING IN ALBANIA

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ABSTRACT

Intergovernmental transfers from the central government to the local level are an important source of revenues in Albania. While the need for capital investment and other local services is rapidly increasing, local budget management has become a key point of discussion. Own revenues of local governments are still unconsolidated and unconditional transfers cover about 50% of the local budget. Although Albania has undertaken major reforms in the field of intergovernmental relations, still the transfer mechanism must resolve issues such as the determination of total transfer and distribution of this fund to the local government. Regarding the determination of the total fund, there is still no fixed formula, which complicates its prediction by local units and it also makes the distribution scheme less understandable and transparent. This study is focused on the system of intergovernmental transfers in Albania, especially in unconditional transfers, utilizing qualitative and quantitative data and by applying econometric analysis to test the system regarding politically motivated targeting of transfer allocation.

KEYWORDS: Intergovernmental Relations, Unconditional Transfer, Politically Motivated Targeting, Local Government Revenues, Electoral Effects, Transfer Allocation

INTRODUCTION

Municipal finance management is an important issue in Albania nowadays. In most countries, local leaders continue to be highly dependent on central transfers, although the theory of public finance promotes the opposite. Intergovernmental transfers in Albania constitute a key source of income and as a result local governments are highly dependent on the central government. In countries where local leaders are responsible for basic urban services, and not for social services, expected income of local government unit comprise 12 % to 15 % of state income and 5 % to 7 % of GDP. In Albania, local government revenues comprise only 11 % of the state budget and 2.9 % of GDP (Ministry of Finances, 2012), figures which are lower than international levels. Although Albania has undertaken major reforms in terms of intergovernmental relations, there are still some controversial issues that need to be addressed. Own revenues of local governments are still unconsolidated and unconditional transfers cover a significant part of the local budget. Thus, the determination of transfers is of critical importance to the success of decentralization process. Meanwhile, the impact of politically motivated targeting in intergovernmental relations, especially in distribution of unconditional transfer, has always been a peak topic in political arena of our country.

Intergovernmental transfers are always at the center of political discussion, especially in the case of countries in transition. First of all, the transfer level (or total revenue of local governments) is much smaller than what is considered sufficient by local leaders. Secondly, the central level politicians always consider transfers as a means to increase their political influence. There are numerous world evidences which show the intervention of political and electoral factors in

the system of intergovernmental transfers. Many countries have adopted a system of grants distribution in the form of a formula defined by law. But even in these cases, there is a possibility of manipulating the formula or adjusting it to attain certain political targeting. There may be different ways of displaying this impact, however, three theories are widely known in literature, in developing countries but also in developed democracies.

The first theory, known as Electoral Budget Cycles theory, sums up the fact that the government may engage in expansionary economic policies using monetary and fiscal instruments before the elections, in order to lead to increased production and reduction of unemployment, as influential factors in getting more votes. These short-term policies, which occur in election years, can reduce macroeconomic stability and increase the budget deficit. Although the literature for such a phenomenon in Albania is sporadic, results of existing studies attest to the fiscal expansion cases before elections. According to the study of Lami, E. ; Imami, D. and Kächelein, H. , (2011) : there is a statistically significant increase in public spending before elections, in attempt to improve the overall economic situation, through public investment and increased transfers. There is a broad academic consensus about the negative effects of electoral budget cycles in public sector, therefore they should be avoided.

A second theory shows the practices of biased funds allocation to units that belong to the same political side with the central government. Such an allocation of funds is made in order to enhance voters support to the party in power, while an increased allocation of grants to opposition units would not bring new voters. These practices affect the efficiency of the system, and also reduce the reliability of local leaders to government fiscal policies, so often conflicts arise between the two parties. The main argument concerning political targeting disadvantages is that although fiscal decentralization is accepted by a large number of developing countries, the benefits of this process will fail if the system of intergovernmental transfers is not based on an efficient allocation and equitable funding.

The third element regarding political influences in transfer distribution is also known as the phenomena of “grey area”. Also in this case, the transfer system is not based on accepted principles of horizontal and vertical equity but is used as a mechanism to attract more voters to support the political force in power. Studies indicate worldwide cases of higher resource allocation in those areas that are recognized as neutral, thus not supporting a particular political wing. This phenomenon is observed especially in election years, and as in the case of two other phenomena mentioned above, it brings inefficiency in the system performing against the principles of a well established governmental transfer system.

Hypotheses and questions raised by earlier studies since the 90s until today, encourage academic and public debate on the system of intergovernmental transfers regarding the influence of politically motivated targeting. It is highly relevant to study such influential elements in our country, with a narrow focus on analytical and reliable scientific methods.

LITERATURE REVIEW

Intergovernmental transfer is a kind of fiscal revenue transfer from central government to local government, for the purpose of long-term development of the economy, and to play an important role in the leveling of social inequalities between areas (Pigou, 1928). According to Pigou, fiscal redistribution can help create equality of welfare system (1928). As published in the research study of Oates (1972), fair redistribution of central income is a process that leads to higher levels of government.

Empirical evidences from many countries show indicators that represent the influence of political characteristics of certain administrative unit to intergovernmental transfer allocation. One of the reasons for adopting a scheme by formula

comes as an effort to limit the politically motivated targeting of funds. However a question remains still unanswered, is it sufficient to eliminate political motivations in grant distribution by the use of formula? According to the theory (Buchanan, 1950; Samuelson, 1954; Musgrave, 1959; Oates, 1972, 1999) allocation of transfers influenced by political motivations results in inefficient allocation of resources across geographic regions and social disparity between classes, ethnic groups or religious. Some of the countries with evidences of such phenomenon in the worldwide literature are: Albania (A. Case, 2001), India (Khemani, 2007; Cole 2009; Arulampalam, Dasgupta 2009), Argentina (Porto and Sanguinetti, 2001), Australia (Worthington and Dollery, 1998), Sweden (Dahlberg and Johansson, 2002) and United States (Wright, 1974; Wallis, 1997, 1998, Anderson and Tollison, 1991; Grossman, 1994). In developing countries there is a great need for development resources so it is often impossible to determine whether a transfer is influenced by political bias. Further distribution of certain public goods to areas of specific electoral features, not necessarily mean an unfair advantage for that area (Alesina, Baqir and Easterly, 1999). In our country there is evidence of increased grants for certain districts during electoral processes before year 2001 (A. Case, 2001).

Another concept related to political and electoral motives in grant transfer system is known as Political Budget Cycle (PBC) or Political Fiscal Cycle (PFC). This phenomenon was first introduced by Nordhaus (1975), explaining the manipulation of economy for electoral purposes. Using economic instruments, governments gain electoral advantage by promoting economic growth or investments before the elections. There is evidence of this phenomenon also in Albania, as the results of existing studies attest the cases of fiscal expansion before elections (Lamy, E., Imam, D., and Kächelein, H., 2011). One of the studies on political budget cycle was conducted by Alberto Alesina and Nouriel Roubini (1990). They analyzed data from the last decade for 18 of OECD countries and studied the relationship between macroeconomic variables and election results. According to this study there was no evidence of opportunistic behavior of Nordhaus type, except in two cases (Germany and New Zealand). However, results showed the influence of electoral cycles in inflation rates changes. As shown by several of the latest researches, the PBC phenomenon is also present in countries with developed democracy.

METHODOLOGY

The aim of this paper is to analyze the system of intergovernmental transfers in Albania, with focus in unconditional transfer, regarding to the impact of political and electoral motivations in fund distribution. The research analysis is conducted on the hypothesis: "Is there any relation proven between politically motivated targeting of unconditional transfer and the allocation of fund?"

Analyzed Data

The data taken in analysis are secondary data, based on previous studies and official statistics of public institutions such as the Ministry of Finance, INSTAT, Bank of Albania, and Census 2001-2011. The population selected for the study of intergovernmental transfers includes 373 units of local governments (municipalities and municipal districts). The collected data are both qualitative and quantitative, to accomplish the analysis by use of econometric methods. Study interval is the ten year period from 2003 to 2013.

Methods of Analysis

The main hypothesis of the study is tested by conducting three econometric tests as explained below:

- **Test 1:** Analysis of Variance and Regression (ANOVA) - to test the relationship between two variables: the level of unconditional transfers allocated to the local units and the percentage of votes won by the ruling coalition during the latest local electoral process. The period of study was divided in two intervals: in the first interval the results of 2011 local elections are tested for the transfer of each following year (2012, 2013); for the second interval the results of 2007 local elections are tested for the transfer level of each following year (2008, 2009, 2010, 2011). Significance level alpha=0.05.
- **Test 2:** Univariate Analysis of Variance - to test the relationship between two variables: the level of unconditional transfers to each local unit and the political wing of each elected leader in the latest local elections. Data were grouped into three categories. Significance level alpha=0.05. The period of study was divided into two intervals.
- **Test 3:** Chi Square Test – analysis of two categorical variables to test the correlation between the percentages of change for the unconditional transfer of two consecutive years with the political affiliation of governing leaders of each local unit. Again, the data were grouped in three categories as in test 2 and allocated in two intervals (as in the case of tests 1 and 2).

RESULTS

Test 1 - Linear Regression Analysis

The hypotheses to test the relationship between transfer level distributed to each local unit (commune, municipality) and the percentage of votes won in the local elections by the ruling coalition (the winning coalition in parliamentary elections) are:

H_0 = unconditional transfer level is independent of the percentage of votes won by the ruling coalition. (H0: $\beta 1 = 0$)

H_1 = unconditional transfer level is dependent on the percentage of votes won by the ruling coalition. (H1: $\beta 1 \neq 0$)

In the first interval, analysis showed that for the regression of unconditional transfer of 2012 and the percentage of votes won by the ruling coalition in local elections of 2011, the significance criterion α is greater than p value (0.74> 0.05), therefore null hypothesis is not rejected. For the analysis of year 2013 the resulted p was equal to 0.91, since 0.91> 0.05 then p> α, the null hypothesis is not rejected. So regression indicators which (summarized in Table 1 and Table 2) did not show a significant correlation between the level of transfer for the interval 2012-2013 and percentage of votes won by the ruling coalition in 2011.

Table 1: Results of ANOVA analysis for the Regression of Unconditional Transfer of 2012 with the Elections of 2011

ANOVA 2012					
	df	**SS**	**MS**	**F**	**Significance F**
Regression	1	373502377	373502377	0.10405	0.747199981
Residual	371	1331710851779.72	3589517121		
Total	**372**	**1332084354156.69**			

Table 2: Results of Linear Regression Test for the Year 2012

	Coefficients	**Standard Error**	**t Stat**	**P-Value**	**Lower 95%**	**Upper 95%**	**Lower 95.0%**	**Upper 95.0%**
Intercept	31920.8343	12288.08164	2.597706885	0.00976	7757.811905	56083.8566	7757.811905	56083.8566
X Variable 1	-7678.09587	23802.62529	-0.32257349	0.7472	-54483.07197	39126.8802	-54483.072	39126.8802

For the second interval, the results for the regression of unconditional transfer (for each year: 2011, 2010, 2009, 2008) and the percentage of votes won by the ruling coalition in local elections of 2007, were similar to the first interval. According to the criterion F and p, there was no significant value to refute the null hypothesis. For 2011 the obtained value was p = 0.42, greater than α of 0.05. Also in 2010, obtained p was equal to 0.423, insufficient to reject H_0. Test result for 2009 estimated the value p=0.41, greater than the significance level alpha. And finally regression test for the level of transfer of 2008 resulted in p= 0.42, also in this case the criterion was not sufficient to reject the null hypothesis.

According to Test 1 results, there is no significant relationship between two indicators: level of unconditional transfer and political support (expressed in % of votes).

Test 2-Univariate Analysis of Variance

Analyzed variables were coded as follows in three categories: o Local units with leaders belonging to the ruling coalition - I o Local units governed by leaders of the opposition coalition - O o Local units with other selected leaders - A

H_0 = unconditional transfer rate is independent of the political affiliation of local leaders. (H0: $\beta 1 = 0$) H_1 = unconditional transfer rate is dependent on the political affiliation of local leaders. (H1: $\beta 1 \neq 0$)

The data correlation for the transfer of 2012 and the political affiliation of local leaders for each local unit, resulted in p =0.361 which is greater than alpha = 0.05, so the null hypothesis cannot be rejected. For the year 2013 also, the null hypothesis cannot be rejected, given that the resulted p was equal to 0.53, so p> α. The univariate analysis test for the first interval 2012-2013, gave insignificant results to reject the null hypothesis.

For the second testing interval, analysis of year 2011 resulted in p = 0.518, greater than the criterion alpha of 0.05, indicating that the null hypothesis is not rejected. For 2010 the resulted variable p = 0.534 is insufficient to refute the null hypothesis (β1=0). However, different results were derived when the analysis was conducted for the year 2009 and 2008. The results of analysis for year 2009 are represented in Table 3 and Table 4.

Table 3: Data for between-Subjects Factors

		N
Wining coalition 2007	A	35
	I	224
	O	117

Table 4: Results of Univariate Analysis of Variance for the Year 2009
Dependent Variable: Unconditional Transfer of 2009

Source	Type III Sum of Squares	df	Mean Square	F	Sig.
Corrected Model	30872403228758.812[a]	2	15436201614379.400	13.300	.00000263443643
Intercept	28202799728904.100	1	28202799728904.100	24.299	.00000124323157
Wining Coalition 2007	30872403228758.700	2	15436201614379.300	13.300	.00000263443643
Error	432921459457274.000	373	1160647344389.480		
Total	**469504678846343.000**	**376**			
Corrected Total	**463793862686033.000**	**375**			

According p criterion for 2009, the result was very close to zero (approximately 0.0000023), lying within the critical interval of $-0.05 < \alpha < 0.05$. This shows that there is a strong relation between the two indicators and a reliable result to accept the alternative hypothesis H_a. Analysis for 2008, also estimated an approximate criterion p=0.0000045, a variable near zero which indicates that the null hypothesis cannot be accepted.

Although the results for the first interval (2012-2013) were insignificant to refute the null hypothesis, the analysis of second interval (2008-2011) resulted in significant value of p, very close to zero, which means that the probability value is significant to reject the null hypothesis. Expressed in other terms, as we initially defined the alternative and null hypothesis, for the years 2008 and 2009, the univariate analysis of variance revealed an important link between unconditional transfer distributed to local government units and political affiliation of local leaders.

Test 3 - Chi Square Test

The hypothesis tested by the Chi square test:

H_0 = The percentage of change for the unconditional transfer of two consecutive years is independent of political affiliation of local government leaders. (H0: $\beta 1 = 0$)

H_1 = The percentage of change for the unconditional transfer of two consecutive years is dependent on political affiliation of local government leaders. (H1: $\beta 1 \neq 0$)

The selected variables are respectively: percentage of change for the unconditional transfer from one year to another $(t_1-t_o)/t_o$, and the political affiliation of local leaders, for each unit of local government. These indicators are coded in SPSS in the following categories:

Percentage of Change for the Unconditional Transfer

- **Category 1-** when the percentage of change for one unit of local government is greater than that of the total fund.
- **Category 2-** when the percentage of change for one unit of local government is smaller than that of the total fund.

Political Affiliation

- Local units with leaders belonging to the ruling coalition - I
- Local units governed by leaders of the opposition coalition - O
- Local units with other selected leaders – A

For the first interval we analyzed the change of transfer for the year 2013-2012, grouped into two categories. According to this test, for the year 2013-2012, resulted that p = 0.481 (results presented in Table 5 and Table 6). For the years 2012-2011, the test estimated p = 0.631, which is again outside the alpha level of significance. For the first interval, the Chi square test did not result in statistically significant coefficient p to accept the alternative hypothesis so the null hypothesis is not rejected.

Table 5: Data for Chi-Square Test, Interval 2013-2012

		Wining Coalition 2011			Total
		A	I	O	
Change of transfer	1.00	6	91	62	159
	2.00	14	122	78	214
Total		**20**	**213**	**140**	**373**

Table 6: Results of Chi-Square Test for the Interval 2013-2012

	Value	df	Asymp. Sig. (2-Sided)
Pearson Chi-Square	1.462[a]	2	.481
Likelihood Ratio	1.512	2	.470
N of Valid Cases	373		

For the second interval, which corresponds to the 2007 local election results, we obtained p = 0.502 for the period 2011-2010, p is greater than alpha = 0, 05. During the period 2010-2009, test resulted in p = 0.497, also in this case greater than alpha. The p criteria calculated for 2009-2008 is 0.938, again outside the confidence interval of alpha, which means that there is a statistically significant result to refute the null hypothesis. However the results for the analysis of the period 2008-2007 were different, as shown in Table 7. Chi test for this period resulted in p = 0.011 which is within the confidence interval $0.05<\alpha<0,05$. This is a statistically significant result that shows a relation between the two variables for which the null hypothesis ($\beta1=0$) cannot be accepted.

Table 7: Chi-Square Test Results for the Interval 2008-2007

	Value	df	Asymp. Sig. (2-Sided)
Pearson Chi-Square	9.061[a]	2	.011
Likelihood Ratio	9.310	2	.010
N of Valid Cases	373		

In other words, for the interval 2008-2007, the results of statistical test Chi-square showed that there is a significant relation between the political affiliation of local leaders and the percentage of change for the unconditional transfer fund during two consecutive years to local units of government.

The fact that in three econometric tests, for different years, there are results that show a dependency relation between the unconditional transfer level and the political characteristics of local government units should encourage further studies and deepening the analysis for more concrete evidence of the phenomenon.

CONCLUSIONS

The econometric analysis conducted in the study, applying three econometric methods to test the hypothesis formulated for the purpose of examining the political influences in unconditional transfer distribution, revealed the above conclusions:

- According to Test 1 results, there is no significant relationship between two indicators: level of unconditional transfer and political support of the ruling coalition.
- For the years 2008 and 2009, the univariate analysis of variance revealed an important link between unconditional transfer distributed to local government units and political affiliation of local leaders.
- The results of Chi-square test for the interval 2007-2008, show that there is a significant relation between the political affiliation of local leaders and the percentage of change for the unconditional transfer fund during two consecutive years.
- As indicated from the conducted analysis, for different years, there is evidence of a relation between political characteristics of a certain local government unit and the level of unconditional transfer distributed to that unit.

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